IN THE

Supreme Court of the United States

October Term, 1974

Docket No. 74-742

FOREMOST-McKESSON, INC.,

Petitioner,

v.

PROVIDENT SECURITIES COMPANY,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF FOR THE PETITIONER

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BRIEF FOR THE PETITIONER

Opinions Below

The opinion of the Court of Appeals (1a),* is reported at 506 F. 2d 601 (9th Cir. 1974). The opinion of the District Court (30a) is reported at 331 F. Supp. 787 (N.D. Cal. 1971).

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* References in this form are to the Appendix to the Petition for Certiorari. References in the form "A....", are to the indicated page in the Appendix filed pursuant to Rule 36. References in the form "R...." are to the indicated page in the Record.

Jurisdiction

This Court's jurisdiction is invoked under 28 U.S.C. §1254(1). The judgment of the Court of Appeals for the Ninth Circuit was entered on September 19, 1974 (A2) and the petition for certiorari was filed within ninety days of such date. The petition was granted on February 18, 1975.

Statutes and Rules Involved

48 Stat. 896, 15 U.S.C. §§78c, 78p are set forth in the attached Appendix at page App-1. 17 C.F.R. §§240.16a-3, 240.16a-4 and 240.16b-2 are set forth at page App-4. California Corporations Code, §§4607, 4618, 4800, and 4801 are set forth at page App-7.

Questions Presented

1. When a corporate holder of 10% of the equity securities of an issuer who "could well have had access to confidential corporate information" sells such equity securities at a profit within six months of their purchase, is such holder liable for such profit under Section 16(b) of the Securities Exchange Act of 1934 where the only purchase within the six-month period is the one by means of which it became a 10% holder, or must there be an independent purchase thereafter in order for liability to attach?

2. In determining whether a "purchase" in terms of Section 16 has occurred, does a transaction which would be considered "orthodox" if cash had been exchanged for securities become "unorthodox" for purposes of measuring

the potential for abuse if payment of the purchase price is instead made by exchanging other property, to wit, corporate assets, for securities?

3. If the transaction in the case at bar was unorthodox, did it nevertheless involve the potential for speculative abuse where the prospective purchaser had acted voluntarily, had "conferred intimately" with the issuer's management and "could well have had access to confidential corporate information" prior to the purchase and sale?

4. Is Provident exempt from Section 16(b) liability on grounds that it was a "liquidating agent", when the uncontested facts demonstrate that it was not a court supervised fiduciary and was acting for itself in both buying and selling the securities?

Statement of the Case

A. Proceedings Below

Provident filed its complaint (A3) for a declaratory judgment on March 3, 1970, seeking a determination: (1) that it had not violated Section 16(b) as a result of certain transactions in Foremost 6% Convertible Subordinated Debentures (the "Debentures") described in the complaint; and (2) that it was not liable to Foremost for any Section 16(b) profits as a result thereof. Foremost's answer and counterclaim (A8) seeking recovery of the Section 16(b) profit was filed on May 28, 1970.

On August 14, 1970, while discovery was progressing in the present action, Provident filed in the California Superior Court, City and County of San Francisco, a

Report and Petition with respect to its Winding Up and Dissolution (A32). In that Petition, Provident described this litigation, and asked that $312,500 be set aside in a liquidating trust "to cover any award of damages to Foremost from the Section 16(b) claim" (A32-33). Provident stated that "such sum represents the amount that was received from the sale of the Debentures in excess of their face amount." By order filed August 31, 1970, the state court provided for a liquidating trust, and after considering a submission by Foremost as to the Section 16(b) claim, but "without deciding the merits," required that $804,000 be set aside for such claim (A62).

By notice of motion filed October 27, 1970, Foremost moved for summary judgment on the issue of liability (R84). Provident filed its cross-motion (R179) on June 14, 1971, and both motions came on for argument before Judge Schnacke on August 18, 1971. The court's opinion denying Foremost's motion and granting Provident's motion was filed on September 15, 1971 (30a, A1).

Foremost appealed from that decision and the matter was argued and submitted to the Ninth Circuit on November 14, 1973. The decision of the Ninth Circuit affirming the judgment below, but on wholly different grounds, was filed on September 19, 1974 (1a, A2). Foremost's petition for certiorari was granted on February 18, 1975.

B. The Statement of Facts

The basic facts are undisputed.

On September 25, 1969, Provident entered into an agreement to sell its assets to Foremost for $54,000,000, consist-

ing of $4,250,000 in cash and $49,750,000 face amount of Debentures. The closing under this agreement took place on October 15, 1969, at which time Foremost delivered to Provident at least $40,000,000 of the Debentures, which Debentures were immediately convertible into more than 10% of Foremost's Common Stock. On October 21, 1969, while Provident still held all of such Debentures, it entered into an Underwriting Agreement providing for the sale by it of $25,000,000 worth of the Debentures. The total price paid to Provident by the Underwriters under this Agreement was more than $350,000 in excess of the face amount of such Debentures. These key facts involve a purchase and sale of equity securities within a six-month period at a profit by a statutory "insider". We submit that these circumstances require the insider, under Section 16(b) of the Securities Exchange Act of 1934, to account to the issuer for the profit realized.

The following recitation of facts is but an elaboration on the foregoing:

1. The Purchase Transaction

In late 1968, Provident, a holding company, tentatively decided to liquidate and employed Dillon, Read & Co. ("Dillon, Read") to analyze its current financial structure in great detail (A137). A memorandum dated November 6, 1968, was prepared and updated on January 24, 1969 (A137). In these memoranda the complexities of Provident's assets and operations were analyzed and the need for detailed knowledge and expert judgment in evaluation were set forth. For example, Dillon, Read noted that the

development of the Crocker Estate properties "is a very complex problem and will probably take years to work out. * * * The success, or lack of success * * * will be dependent primarily on real estate management skills of the highest order and astute financial planning" (A152). As recommended by these studies, Provident employed Dillon, Read as investment bankers to search for suitable purchasers and "to negotiate and analyze * * * any offers which may result * * *" (A153).

As a result of this search, Foremost and Provident entered into negotiations and on September 25, 1969, a Purchase Agreement (A35) was signed providing for the sale to Foremost of approximately two-thirds of the assets of Provident (including real estate and certain securities for which there was no readily available market) for a total purchase price of $54,000,000. The $54,000,000 was to be paid $4,250,000 in cash and $49,750,000 in Debentures, which class of securities was created solely for the purpose of this transaction. The Debentures contained an absolute and an immediate conversion privilege (R650).

Provident negotiated to include in the Purchase Agreement provisions that would permit it (or its shareholders) to sell $25,000,000 principal amount of the Debentures in a public offering at any time over a period of many years, commencing promptly after the date of closing (October 15, 1969) of the Purchase Agreement (A25-26). To this end, because the Securities Act of 1933 permits only an issuer of securities to file a registration statement with respect to its securities, the Purchase Agreement contained Foremost's agreement to "use its best efforts to cause a registration statement [to be filed] covering such aggregate principal amount of the Debentures, up to $25,000,000, as is requested by [Provident] * * * as soon as practicable after the date hereof" and to "enter into an Underwriting Agreement in substantially the form of Exhibit D annexed hereto" (A35, ¶5(k)(i)).

On September 25, 1969, a hearing was held in San Francisco by the Department of Corporations of the State of California in connection with the application of Foremost for a Permit to issue the above-described Debentures in connection with its acquisition of the assets of Provident (A37). At that hearing, a partner of Dillon, Read, Provident's financial advisor, described certain calculations as a result of which "you come up with a valuation of $54,000,000. And that is the valuation on the assets to be purchased by Foremost McKesson * * *" (A42). When questioned as to whether the transaction was fair, just and equitable to the shareholders of Provident, he added:

> "We think it's fair because we think that based on our experience and a review of the assets of this Company [Provident] we are getting a fair price for these assets" (A 46).

The Permit to offer, sell and issue the Debentures "for the consideration, uses and purposes, and in the manner set forth in said application" was issued to Foremost on September 30, 1969 (A50).

2. Interim Events

On October 13, 1969, the Board of Directors of Provident adopted a resolution to the effect that after Provident transferred the assets to Foremost in exchange for the Debentures, Provident would distribute all of the Debentures to its shareholders at an undetermined future time "upon dates established by" the officers of Provident (A79, A120). This resolution did not fix any date for the contemplated distribution and it was never implemented in the manner expressed therein,—$25,000,000 principal amount of the Debentures were instead sold directly by Provident in a public offering.

According to the papers submitted below by Provident (A80) it had realized early in October that there were several difficulties in having its shareholders make the public offering of the Debentures. In particular, it was impossible to obtain consents from the minor shareholders and one other shareholder who was in the Brazilian jungles. Consequently, Provident ignored the Board resolution and, at an informal meeting of its shareholders on October 13, 1969, obtained the consent of two-thirds of its preferred stockholders and a majority of the common shareholders to make the sale directly, without prior distribution to the shareholders (A80-81). This sale, in obvious negation of the October 13 resolution, was subsequently ratified by a resolution of Provident's Board of Directors adopted at a December 9, 1969, meeting (R70).

The agenda for the October 13 shareholders' meeting (A126) included as Item 3 the "Section 16(b) Problem". The President of Provident, Mr. Charles de Limur, in his

affidavit below identified the agenda as a "true copy of the agenda of the meeting" and went on to state that at the meeting, "I explained the various alternatives and problems to the shareholders" (A80). Such explanation must have included the contemplated "Section 16(b) Problem".

On October 15, 1969, the closing was held under the Purchase Agreement (as amended that day to include certain minor adjustments in the assets to be transferred) and Foremost delivered to Provident a check for $4,250,000 and a Debenture in the principal amount of $40,000,000 (immediately convertible under the formula set forth in Article 5 of the Trust Indenture of the same date into 1,303,632 shares of common stock, more than 10% of the outstanding stock) (A29). At the same time, Foremost delivered on Provident's behalf to the Bank of America National Trust and Savings Association as escrow agent, a Debenture in the amount of $2,500,000 (immediately convertible into 81,539½ shares of common stock). Thereafter, on October 20, 1969, by virtue of certain post-closing computations contemplated by the September 25 Purchase Agreement, a Debenture in the principal amount of $7,250,000 (immediately convertible into 236,464½ shares of common stock) was delivered by Foremost to Provident (36a, A29).

By letter of October 16, 1969, in preparation for the public offering, Provident directed the Trustee to exchange the $40,000,000 Debenture certificate for two certificates, one in $15,000,000 principal amount, the other in $25,000,000 principal amount, both such certificates to continue to be "held by you subject to our further order" (36a, A19, A30).

3. The Sale Transaction and Thereafter

On October 21, 1969, the Underwriters, Provident and Foremost entered into an Underwriting Agreement substantially in the form of Exhibit D to the Purchase Agreement, providing for the sale by Provident of $25,000,000 principal amount of Debentures to the Underwriters at a price of 101¼% of their aggregate principal amount (or $25,312,500.00), plus interest accrued from October 15 to the date of closing (amounting to $54,166.66), or a total price of $25,366,666.66. This price, paid by the Underwriters, was negotiated by the Underwriters and Provident in San Francisco on October 20, 1969 (36a, A31, A135).

Thereafter, on October 22, 1969, Provident delivered to the Trustee a letter dated the previous day (A21), directing it to distribute on October 24, 1969, the other $22,250,000 aggregate principal amount of Debentures (consisting of the $15,000,000 Debenture and the $7,250,000 Debenture described above) held by Provident to its shareholders. Such distribution (except for $23,000 representing fractional interests) was carried out as directed by Provident on October 24, 1969 (36a, A31).

On October 28, 1969, the closing under the Underwriting Agreement was held and the $25,000,000 principal amount of Debentures were transferred by Provident to the Underwriters who in turn delivered a check in the amount of $25,366,666.66 to Provident (36a, A32).

At all times between September 25, 1969 and October 30, 1969 there were never less than 11,111,754 nor more than 11,211,027 shares of Foremost Common Stock actually

issued and outstanding. These securities were and are registered pursuant to Section 12 of the Securities Exchange Act of 1934 (A30).

Provident filed Forms 3 and 4 dated October 31, 1969, pursuant to the requirements of Section 16(a) of the Securities Exchange Act of 1934 and Rule 16a-1 adopted thereunder (17 C.F.R. §240.16a-1), applicable to beneficial owners of 10% or more of a class of equity securities of Foremost.* The Form 3 (A53) reported the acquisition of $47,250,000 aggregate principal amount of Debentures pursuant to the September 25, 1969 Purchase Agreement. The Form 4 (A55) reported the sale as of October 21, 1969, of $25,000,000 aggregate principal amount of Debentures by Provident and the subsequent distribution on October 24, 1969, to its shareholders of $22,227,000 principal amount of Debentures as a liquidating dividend (A32). Thus, we submit, all the requisite elements of §16(b) liability coalesced. Provident, a beneficial owner (through the conversion right) of more than 10% of the equity securities (Common Stock) of Foremost registered pursuant to Section 12 of the 1934 Act, purchased (on September 25, 1969 when the Purchase Agreement was signed) and sold (on October 21, 1969 when the Underwriting Agreement was signed) such securities at a profit within a six-month period.

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* In its SEC Forms 3 and 4, Provident made no disclaimer of beneficial ownership, although such a statement is expressly permitted under Rule 16a-3, 17 C.F.R. §240.16a-3.

C. The Decisions Below

1. The Opinion of the District Court

District Judge Schnacke's opinion, granting Provident's motion for summary judgment, and denying Foremost's motion, did not analyze the facts in terms of the requirements of the statute—that is, in terms of whether there was: (1) a purchase and sale, (2) of any equity security of the issuer, (3) within any period of less than six months, (4) by a beneficial owner of more than 10% of any class of any equity security. He did not find any material issues of fact which would bar Foremost from summary judgment. Nor did he accept the contentions of Provident that for various asserted legal reasons it was exempt from Section 16(b). Instead, the court held that it would "perpetrate * * * an inequity" to permit recovery by Foremost (41a).

The court did find that the Purchase Agreement was executed on September 25, 1969 (32a) and closed on October 15, 1969 (35a) and that the Debentures were delivered to Provident as called for by that Agreement (35a). It made no suggestion—nor was it argued by Provident—that the Debentures were not "equity securities" within the meaning of Section 16(b), or that Provident's ownership of more than $40,000,000 of said Debentures was less than ten percent of a class of equity securities. The court acknowledged that the sale was made by Provident (36a), and that the Underwriting Agreement, by which the sale was made, was executed on October 21, 1969 (36a). This was prior to Provident's distribution of the other Debentures to its shareholders (36a), so that its percentage ownership was thus greater than 10% on that date. The court

explicitly acknowledged that Provident had realized a profit on the transactions (41a), although it characterized it as "small" and "almost miniscule" in comparison to the overall transaction involving $54,000,000.

The court apparently conceded that "a starkly literal reading of Section 16(b) * * * would make Provident, by virtue of its short-lived position as holder of the convertible debentures of Foremost, accountable to it as provided in 16(b) for the relatively small profit resulting from the underwriting * * *" (38a). However, the court refused to accept such a literal reading, and referred to language in three cases (none of which involved analogous factual situations) which indicated that in certain circumstances, the court should determine whether a "potential for abuse" was involved and whether the imposition of liability would further the purposes of the statute (38a-40a). Without actually analyzing the issue of the possibility of abuse on the facts involved or whether the purposes of Section 16(b) would, in fact, be furthered by a decision in favor of Provident, the court simply held:

> "To allow Foremost under these circumstances to recover the small profit of Provident (almost miniscule in terms of the total amounts involved) simply by a mindlessly literal application of Section 16(b) would be to perpetrate rather than correct an inequity" (41a).

2. The Decision of the Court of Appeals

On appeal, the Ninth Circuit declined to follow the approach of the District Court but nevertheless affirmed the District Court on other grounds—grounds not even urged by Provident. The Court of Appeals analyzed the

case in terms of the statute, finding that at least by the time of the closing on October 15, 1969, Provident had become by purchase a beneficial owner of more than 10% of a class of Foremost's equity securities (3a). Furthermore, the court held that when six days later, on October 21, Provident executed the Underwriting Agreement, its sale of the Debentures was complete (10a). In addition, although the question of damages was not before it, the court explicitly acknowledged the fact that the sale was in an amount of $366,666.66 in excess of the face amount of the Debentures (3a). Moreover, the court held that the transaction, involving the transfer of Provident's assets for Foremost securities and resulting in Provident becoming a more than 10% holder, was not "unorthodox" and further adopted Foremost's position that in such circumstances the question of whether there was a potential for speculative abuse was not even applicable (4a-6a). However, the court went on to hold that if the Foremost-Provident transaction were to be considered unorthodox, in terms of this Court's decision in *Kern County Land Co.* v. *Occidental Petroleum Corp.*, 411 U.S. 582, 595 (1973) (hereafter "*Kern County*"), nevertheless "it involved the potential for speculative abuse of inside information and therefore is subject to section 16(b) scrutiny" (6a-8a). In reaching that conclusion, the court noted that Provident, as a holder of 10 percent of the equity securities, could reasonably be presumed to have had access to inside information and further distinguished this case on its facts from one such as *Kern County* which involved a hostile tender offer, saying:

> "To the contrary, the general cooperation involved in the transaction would indicate that Provident conferred intimately with the Foremost management and could well have had access to confidential corporate information." (7a)

The court also agreed with Foremost that the Provident purchase and sale were voluntary and that indeed Provident had entered into the transaction when it was aware of the Section 16(b) problem and "in spite of the possibility that it might be held liable for the profits" (7a-8a).

Despite all of this, the Court of Appeals nevertheless concluded that Section 16(b) did not apply because Provident was not a 10% owner *prior* to its purchase of the Debentures. This issue was not mentioned by the District Court, not urged by Provident, and not dealt with by either party during oral argument before the Ninth Circuit. The key statutory language provides:

> "This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved * * *."

In construing this language to require that before the statute can apply a prior beneficial ownership of more than 10% of a class of equity securities is required, and in holding that the purchase by which one becomes a more than 10% holder of stock is not itself a Section 16(b) "purchase", the court ignored many of the considerations hereinafter discussed. It did, however, acknowledge that it was placing itself in direct conflict with the position adopted in two other circuits, the Second and Eighth (12a-13a). (In fact, it was taking a stance also at odds with that of other circuits as to the analogous issue of the Section 16(b) liability of officers and directors.) The court based its conclusion primarily on its construction of certain language

in the *Kern County* case (14a-15a) and on that portion of the legislative history of Section 16(b) which it viewed as supportive of its position (15a-25a).

The Court of Appeals conceded that in order to reach its conclusion, it was necessary to read the phrase "at the time of" in Section 16(b) to mean "prior to" in reference to the purchase half of a purchase and sale transaction, but to mean "simultaneously with" in reference to the purchase half of a sale and purchase (26a-27a). The court further noted that its construction of the statutory language would not prevent all abuses of inside information and specifically would not provide a remedy in a situation—the very situation at bar—where a person might have access to inside information at the time he makes the purchase that makes him a 10% shareholder; nevertheless, the court felt that other remedies under the Securities Exchange Act were sufficient to solve those problems (28a-29a).

Summary of Argument

1. Effectuation of the purposes of Section 16(b) requires that the initial purchase of more than 10% of the issuer's equity security be included within the statutory prohibition, so that there will be automatic divestment of insider profit on any sale within 6 months of such purchase. This is the construction of the statutory language favored by the overwhelming weight of judicial authority and espoused by the Securities and Exchange Commission. Any other interpretation would render an existing exemptive rule under the statute meaningless. Such construction involves neither a tortured construction of language nor in-

consistency with the legislative history. On the contrary, the construction of the four key words adopted by the Ninth Circuit requires that they mean one thing in the case of one type of transaction and another thing in the case of another type. Nothing in either the legislative history of the statute or in this Court's decision in *Kern County* suggests that the initial purchase of more than 10% of a class of equity securities through cooperative negotiations between the potential purchaser and the issuer, in which the potential purchaser could well have access to inside information prior to the ripening of its equity ownership, should be treated as anything but a "purchase" under Section 16(b).

2. The traditional elements of Section 16(b) liability are present here. Thus, the voluntary purchase of Foremost equity securities in exchange for selected assets of Provident was a purchase of more than 10% of a class of such securities. A voluntary sale of certain of such securities at a profit was made by Provident, the beneficial holder of such securities, within six months of the date of purchase.

3. There are no grounds for exempting Provident's purchase and sale of the Foremost Debentures from the application of Section 16(b). This Court's decision in *Kern County* is not dispositive because the transaction by which Provident became a 10% holder—involving the exchange of assets for securities—was not unorthodox and was voluntary on Provident's part. Moreover, even if the transaction were to be considered unorthodox, there was, as the Ninth Circuit found, a potential for speculative abuse in the transaction.

4. Provident was not a liquidating agent within the meaning of Rule 16a-4. It was at all relevant times acting for itself in the purchase and sale of securities: *e.g.*, it was not a third party authorized by law to administer the estates or assets of other persons—but rather was a competent person having full control over its status and the disposition of its assets. Both the purchase and sale were made by Provident, thus its holding of the equity securities did not devolve upon it by operation of law as required for exemption under the Rule.

ARGUMENT

I

The purposes of Section 16(b) are frustrated by the decision below exempting the initial purchase of 10% of the issuer's stock from the prohibitions of the statute.

A. The Prophylactic Purposes of Section 16(b)

Prior to the enactment of Section 16(b), Congress had uncovered many instances where those in control of large corporations had used inside information or had manipulated the affairs of their corporations to profit from short-term speculative trading in their corporations' securities (see *e.g.* S. Rep. No. 1455, 73rd Cong., 2d Sess. 55-68 (1934)). In enacting Section 16(b), Congress removed the incentive for engaging in such practices by providing that any profits realized by any officer, director or more than 10% beneficial owner of the equity securities of certain corporations (originally the securities of corporations listed on a stock exchange and now more broadly applicable) from a purchase and sale or sale and purchase within

six months would be recoverable automatically by or on behalf of the corporation irrespective of whether the insider had in fact used inside information or engaged in manipulative activity. The courts have recognized the intent of Congress to curb insider abuses and have broadly interpreted Section 16(b) to effectuate that intent.

As the Second Circuit stated in *Feder* v. *Martin Marietta Corp.*, 406 F.2d 260, 262 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970):

> "The judicial tendency • • • has been to interpret Section 16(b) in ways that are most consistent with the legislative purpose, even departing where necessary from the literal statutory language."

This is fully consistent with decisions of this Court giving primary emphasis to the congressional purpose underlying a statute, even "sacrificing, if necessary, the literal meaning in order that the purpose may not fail." *Ozawa* v. *United States*, 260 U.S. 178, 194 (1922).

In its recent decision in *Reliance Electric Co.* v. *Emerson Electric Co.*, 404 U.S. 418 (1972), this Court confirmed the earlier recognition by the Second and Ninth Circuit Courts of Appeal "that the only method Congress deemed effective to curb the evils of insider trading was a flat rule taking the profits out of a class of transactions in which the possibility of abuse was believed to be intolerably great." 404 U.S. at 422. It quoted with approval the statement of the Seventh Circuit:

> " 'In order to achieve its goals, Congress chose a relatively arbitrary rule capable of easy administration. The objective standard of Section 16(b) imposes

strict liability upon substantially all transactions occurring within the statutory time period, regardless of the intent of the insider or the existence of actual speculation. This approach maximized the ability of the rule to eradicate speculative abuses by reducing difficulties in proof. Such arbitrary and sweeping coverage was deemed necessary to insure the optimum prophylactic effect.' *Bershad* v. *McDonough*, 428 F. 2d 693, 696 [(7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971)]." *Id.*

Mr. Justice Stewart's majority opinion affirms that in respect of Section 16 "the congressional design" was one "of predicating liability upon an 'objective measure of proof'." 404 U.S. at 425. He recognized the need in respect of the statute to "preserve(s) its mechanical quality" and the inappropriateness of "a judicial search for the will-o-the-wisp of an investor's 'intent' in each litigated case." *Id.* In footnote 4, the majority adds that in no respect is liability predicated upon "considerations of intent, lack of motive, or improper conduct 'that are irrelevant in §16(b) suits'." 404 U.S. at 424, citing *Blau* v. *Oppenheim*, 250 F.Supp. 881 (S.D.N.Y. 1966). Moreover, and most significantly, "where alternative constructions of the terms of §16(b) are possible, those terms are to be given the construction that best serves the congressional purpose of curbing short-swing speculation by corporate insiders." *Id.*

B. The Clear Weight of Authority Has Held the Initial Purchase of 10% of the Issuer's Stock Subject to the Restrictions of Section 16(b).

Transactions of the type effected by Provident in the instant case present the potential for the speculative and manipulative abuses which Section 16(b) was designed to

prevent. The fact that Provident was not a more than 10% beneficial owner prior to its purchase of the Foremost Debentures but became such a statutory insider simultaneously with such purchase does not take this transaction out of the category of insider trading which is capable of abuse. Effectuation of the statute's prophylactic purposes accordingly requires that Section 16(b) liability be imposed on the profit made on this transaction.

The issue was first raised and exhaustively discussed in *Stella* v. *Graham-Paige Motors Corp.*, 104 F.Supp. 957 (S.D.N.Y. 1952). That case involved a purchase which brought the owner of 6¼% of the issuer's stock to the status of beneficial owner of 21% of the shares. Faced with the arguable ambiguity of the phrase "at the time of", the court construed it to mean "simultaneously with" rather than "prior to". On appeal, the Second Circuit approved District Judge Kaufman's construction. 232 F. 2d 299 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956). The SEC filed an amicus brief in the District Court urging the construction ultimately affirmed by the Second Circuit, having distilled from the legislative history the conclusion "that the Congress intended to include such purchases [*i.e.*, those by which one becomes a more than 10% holder] within the scope of the Act." (Brief for SEC as Amicus Curiae at 6-7, *Stella* v. *Graham-Paige Motors Corp.*)

Among other commentators, Professor Loss has stated that "it is difficult to quarrel with the [Second Circuit's] preference for the construction which would serve to effectuate the legislative purpose and still leave some mean-

ing for the statutory language when there is an ambiguity * * *." 2 L. Loss, SECURITIES REGULATION 1060 (2d ed. 1961). Likewise, Messrs. Cook and Feldman (then SEC Chairman and Special Counsel, respectively) in *Insider Trading under the Securities Exchange Act,* 66 HARV. L. REV. 612, 631-32 (1953), state that to construe the phrase "both at the time of the purchase and sale" so as "to exempt a transaction unless ten percent were held both before and after would destroy the effectiveness of this section * * *".

The *Stella* interpretation has on several occasions been reaffirmed by the Second Circuit, recent examples including *Newmark* v. *RKO General, Inc.,* 425 F. 2d 348 (2d Cir.), *cert. denied,* 400 U.S. 854 (1970), and *Perine* v. *William Norton & Co., Inc.,* 509 F.2d 114 (2d Cir. 1974). The *Stella* interpretation was also explicitly adopted by the Eighth Circuit in *Emerson Electric Co.* v. *Reliance Electric Co.,* 434 F. 2d 918 (8th Cir. 1970), *aff'd on other grounds,* 404 U.S. 418 (1972), the court stating that this construction was consistent with Congress' purpose in enacting the statute and overruling by implication the only court (coincidentally located within the Eighth Circuit), until the Ninth Circuit's decision in this case, to reach a contrary conclusion: *Arkansas Louisiana Gas Co.* v. *W. R. Stevens Investment Co.,* 141 F.Supp. 841, 847 (W.D. Ark. 1956). The *Emerson* case came before this Court on another issue; however, in an amicus brief, the SEC urged the interpretation here urged by petitioner.

Moreover, in addition to the direct holdings of the Second and Eighth Circuits, both the Sixth and the Seventh

Circuits have reached the same result by implication or alternative holding with respect to persons who were both 10% shareholders and officers or directors: *Bershad* v. *McDonough,* 428 F. 2d 693 (7th Cir. 1970), *cert. denied,* 400 U.S. 992 (1971); *Champion Home Builders Co.* v. *Jeffress,* 490 F. 2d 611 (6th Cir.), *cert. denied,* 416 U.S. 986 (1974). At present, this question is again before the Seventh Circuit: *Allis-Chalmers Manufacturing Co.* v. *Gulf & Western Industries, Inc.,* Docket Nos. 74-1266 and 74-1267, the issue having been decided in conformity with *Stella* by the court below, 372 F. Supp. 570 (N.D. Ill. 1974). See also *Simon* v. *Sunasco, Inc.* [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. ¶92,547 (S.D.N.Y. 1970); *Kahansky* v. *Emerson Radio & Phonograph Corp.,* 184 F. Supp. 90 (S.D.N.Y. 1960).

Moreover, numerous cases on both the Circuit and District level have held the initial purchases by officers and directors subject to Section 16(b), even when such purchase was made *before* the individual became an officer or director: *Adler* v. *Klawans,* 267 F. 2d 840 (2d Cir. 1959);* *Blau* v. *Allen,* 163 F. Supp. 702 (S.D.N.Y. 1958); *Blau* v. *Hodgkinson,* 100 F. Supp. 361 (S.D.N.Y. 1951); *Booth* v. *Varian Associates,* 334 F.2d 1 (1st Cir. 1964), *cert. denied,* 379 U.S. 961 (1965) (point assumed without discussion). A "not-yet" director can hardly be said to have more access to inside information than a "not-yet" shareholder

* Indeed, *Adler* v. *Klawans, supra,* in reaching the above-described result, referred to and relied upon the *Stella* decision, while acknowledging that it was not directly applicable, to illustrate "that the purpose of the statute is remedial, rather than penal, and that it must be strictly construed in favor of the corporation and against any person who makes profit dealing in the corporation stock." 267 F. 2d at 846-47.

who is engaged in intensive negotiations preparatory to acquiring a major position in the issuer's equity.

C. Rule 16b-2 Is Without Purpose if the Ninth Circuit's View Is Correct.

The SEC's understanding of the meaning of the statute is reflected not only by its amicus briefs in the *Stella* and the *Emerson* cases, but by its promulgation in 1935 of what is now Rule 16b-2 as amended (17 C.F.R. §240.16b-2), exempting certain underwriting transactions from Section 16(b). Unless a person who acquired 10% of the stock by virtue of an underwriting agreement becomes subject to the statute thereby, the exemption would have been unnecessary. Thus, unlike the view of the legislative history it espoused in the *Emerson* case, the SEC's interpretation of the meaning of "at the time of purchase" is fully consistent with its actions taken in implementation of the purposes of Section 16(b).

The adoption of Rule 16b-2 was preceded by an article by Eustace Seligman entitled *Problems under the Securities Exchange Act*, 21 VA. L. REV. 1 (1934), which discussed the instant problem of statutory construction, concluding that the initial purchase making one a 10% shareholder should be a purchase for 16(b) purposes and that any other construction "would seem to be contrary to the purpose of the Act." *Id.* at 20. Mr. Seligman, however, went on to note that such a construction would create a bar to stock financing and urged that "there is a pressing need for regulations by the Commission exempting financing both in the case of 10% owners and directors." *Id.* at 21. In its amicus brief in *Stella*, the SEC itself stated that this Rule "would not have been necessary * * * unless section 16(b) is given the liberal construction we have suggested." (Brief, p. 7).

So much conduct of so many has for so long been predicated on the almost universally accepted view that the transaction by which one becomes a 10% beneficial owner is subject to the statute, that nothing short of an unassailable, completely compelling justification should at this late date be required in order to cast aside such a substantial body of precedent.

D. The Language of the Statute, Interpreted in Light of the Statutory Purpose, Requires That the Initial Purchase of 10% of the Issuer's Stock Be Subjected to Section 16(b).

The Court of Appeals based its decision primarily on the proviso in Section 16(b) which states that the prohibition of that section does not "cover any transaction where such beneficial owner was not such at the time of the purchase and sale, or the sale and purchase, of the security involved * * *." In essence, the Ninth Circuit concluded that the language of the statute, the legislative history* and a statement of this Court in *Kern County* supported the view that because a person buying 10% of the issuer's stock allegedly could not have based his decision on inside information, then such purchase was not intended to be included within Section 16(b). We respectfully submit that both the premise and the conclusion are wrong, and

* We note that the Court of Appeals was without the benefit of briefing from either party on the legislative history, Provident having determined not to urge this issue on appeal.

that the language of the statute, its legislative history, and the analysis of this Court in *Kern County* all lead to a conclusion opposite to that of the Ninth Circuit.

When a purchase-sale transaction is being considered, the Ninth Circuit reads "at the time of the purchase" to mean "prior to" rather than "simultaneously with." Yet we submit that to say that *when* or *at the time that* the purchase took place Provident owned 10% of the stock involves no straining of the English language. To read "at the time of" as meaning "when" or "simultaneously with" is consistent with the way the statute must be read if a sale-repurchase transaction is under consideration, as the Ninth Circuit conceded (26a-27a). Foremost's position thus has the additional virtue of consistency and does not require a tortured construction.

If there is, however, any ambiguity in the language of the statute, its purpose of "preventing the unfair use of [inside] information" is best carried out by the interpretation here urged:

> "There is no surer guide in the interpretation of a statute than its purpose when that is sufficiently disclosed; nor any surer mark of over solicitude for the letter than to wince at carrying out that purpose because the words used do not formally quite match with it." *Federal Deposit Insurance Corp.* v. *Tremaine,* 133 F. 2d 827, 830 (2d Cir. 1943) (L. Hand, C.J.).

We are of course mindful of this Court's observation in *Emerson Electric* that with respect to the specific language of the proviso, "the legislative history affords no explanation of the purpose of the proviso" (404 U.S. at

424); we do submit, however, that the purpose of Section 16 as a whole is carried out only by the interpretation here urged. Thus the statute is designed to prevent the unfair use of information "obtained by such beneficial owner • • • by reason of his relationship to the issuer." Such information can be obtained prior to the time when one becomes, and in connection with his becoming, a 10% beneficial owner, and still be information obtained "by reason of his relationship to the issuer." As the SEC stated in its amicus brief in *Stella*:

> "A person who acquires a large block of stock in a single transaction normally has access to inside information. He necessarily would deal in the negotiations looking toward the purchase, with either the issuer or an insider holding a large interest in the issuer. In either event he would be in a position to bargain for disclosures not available to the public. It is against abuse of information so obtained as well as of information obtained after representation in management is secured that the section is directed." Brief for SEC as Amicus Curiae at 5-6, *Stella* v. *Graham-Paige Motors Corp.,* 104 F.Supp. 957 (S.D.N.Y. 1952).

The same observation is certainly pertinent here where the Ninth Circuit specifically noted:

> "[T]he general cooperation involved in the transaction would indicate that Provident conferred intimately with the Foremost management and could well have had access to confidential corporate information." (7a)

There were frequent references in the hearings leading to the adoption of the Act to promoters and market manipulators who were granted interests in large blocks of stock prior to a market rise in the shares and who distributed

these shares during the ensuing rise. Such references were discussed in the portion of the Senate Report dealing with Section 16(b). S. Rep. No. 1455, 73rd Cong., 2d Sess. 55-68 (1934). If, under the circumstances discussed in the hearings, the initial purchase is excluded from the calculation of the profits which inure to the corporation, the section would be largely ineffective to prevent one of the prime evils uncovered in the congressional investigation. See S. Rep. No. 1455, *supra*.

Other instances of abuse in contravention of the statutory purpose could occur if the Ninth Circuit's interpretation were adopted. A person could purchase a large block of stock in anticipation of engaging in practices upon becoming an insider which would raise the market price and enable him to sell at a profit. Or, a person could, soon after, and very possibly because of, his purchase of 10% of the corporation's stock, come upon inside information which he could immediately utilize in its sale. The point is placed in even clearer focus if one postulates the purchase by a holder of 9% of an issuer's equity of an additional 50% of the issuer, followed by a sale within 6 months of some or all of such holdings. Under the Ninth Circuit's opinion, such a series of events would not give rise to any Section 16(b) liability because no purchase was ever made by a 10% holder. In each of these cases, the Ninth Circuit's interpretation would leave a large loophole in the application of Section 16(b).

It is no answer to suggest, as the Ninth Circuit does (28a-29a), that Section 10(b) of the Securities Exchange Act, 15 U.S.C. §78j(b), may in many cases provide an alternative remedy, especially when the principal burden of the Ninth Circuit's argument rests on its view of the alleged legislative history. Section 10(b) is by its very terms not self-operative. It only proscribes conduct "in contravention of such rules and regulations as the Commission may prescribe." Rule 10b-5, 17 C.F.R. §240.10b-5, was first promulgated in May of 1942, some eight years after Sections 16 and 10(b) were enacted. Moreover, as this Court affirmed in *Emerson*, when it spoke with favor about the Congressional design of predicating liability upon an objective measure of proof, Section 16(b) does not depend upon proof of intent or of injury to the plaintiff, factors which obviously make Section 10(b) more difficult of enforcement than Section 16(b).

We submit that the legislative history relied upon by the Ninth Circuit is totally inapposite. The language which forms the core of the Ninth Circuit's analysis suggested a limitation of the applicability of the statute to pre-existing beneficial owners, but it appeared only in a bill (S. 2693, 73rd Cong., 2d Sess. (1934)) which never became law.* The bill which provided the actual basis for the present section (H.R. 8720, 73rd Cong., 2d Sess. (1934)) eliminated the limiting language of S. 2693. We submit that the elimination of this limiting language and the substitution in the bill of new language—language which ultimately became the law—all without explicit Congressional comment, hardly supports the Ninth Circuit's conclusion that the limitation included in the old draft should be read into the new bill.

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* S. 2693 was not the only proposed bill which fell by the wayside. *See* H.R. 7852, H.R. 8720, S. 3420 and H.R. 9323, 73rd Cong., 2d Sess. (1934). Why the language of S. 2693 should be given such great weight escapes us.

A further factor which suggests that the *Stella* interpretation was indeed the one contemplated by Congress is the presence in Section 16, as enacted, of subsection (d) exempting:

> "any purchase and sale, or sale and purchase, • • • of an equity security *not then or theretofore held by him in an investment account,* by a dealer in the ordinary course of his business and incident to the establishment or maintenance by him of a primary or secondary market • • • for such security". 15 U.S.C. §78p(d). (emphasis added).

This provision might well have been prompted by concerns such as those expressed in the Congressional hearings that Section 16(b):

> "• • • might prevent arbitrage transactions, because it is very common, in arbitrage, for a man to buy one security and at the same time sell against it an equivalent security. While that process of the arbitrage is going on he might conceivably accumulate more than 5 percent of this security, and he would be the beneficial owner of that 5 percent. He would, of course, have offsetting contracts or obligations against it, but they are not reflected in the definition, which imposes penalties upon a stockholder owning 5 percent or more of a registered security." Hearings on S. Res. 84, S. Res. 56 and S. Res. 97 before the Senate Committee on Banking and Currency, 73rd Cong., 2d Sess., pt. 16 at 7567 (1934) (hereinafter "1934 Hearings"). (Statement of Roland L. Redmond, Attorney for the New York Stock Exchange on H.R. 8720). [At that stage, the draft bill reached down to 5% holders.]

Such problems—and the problems relating to underwritings solved by Rule 16b-2, 17 C.F.R. §240.16b-2, referred to above (p. 24)—would not have arisen if the interpretation adopted by the Ninth Circuit were indeed the interpretation contemplated by Congress.

To return to the discussion of the proviso in the *Emerson* case, we note that this Court there quoted with apparent approval the statement of Eustace Seligman, Esq. (in the very article in which he urged the adoption of what came to be Rule 16b-2) that:

> "[T]he intention of the language was to exclude the second sale in a case where 10% is purchased, 5% sold within three months and the remaining 5% a month later." Seligman, *Problems Under the Securities Exchange Act,* 21 VA. L. REV. 1, 20 (1934), quoted at 404 U.S. 423 n.3 (1972).

In *Emerson* this Court rejected an interpretation of the statute which would have imposed liability on "all sales within six months by one who has gained the position of a 10% owner through voluntary purchase, regardless of the amount of his holdings at the time of the sale" (*id.* at 426), but said nothing about exempting the initial purchase. The interpretation urged by Foremost here is consistent with that adopted by the Court in *Emerson*: we suggest that the language ensures, in the context of a "purchase" transaction analogous to the "sale" transaction involved in *Emerson* (and in Mr. Seligman's example) that one who purchases 7% of the corporation's stock (for purposes of illustration, 7,000 shares) and then another 6%, would not have his profits measured by matching 8% of the shares against a sale of 8% (*i.e.,* 8,000 shares) within 6 months of the date of both purchases. Both in this hypothetical illustration and in the case at bar, the purchase by which one becomes a 10% holder should be subject to the statute and in our hypothetical the purchaser should be

required to disgorge his profits arising only from a matching of 6,000 of the shares sold against 6,000 of the shares purchased. See L. Loss, *op. cit.*, at p. 1060.

In its amicus brief in *Emerson* the SEC analyzed the legislative history and concluded that the purpose of the proviso was to exclude from the statute's coverage those who became 10% shareholders "involuntarily". Brief for SEC as Amicus Curiae at 34, *Reliance Electric Co.* v. *Emerson Electric Co.*, 404 U.S. 418 (1972). This Court rejected such view of the legislative history on grounds that it contradicted the SEC's own reporting requirements and the plain language of the statute. 404 U.S. at 425-27.* No such problems derive from the interpretation suggested here. The statute (Section 16(a)) and the SEC require the reporting of the transaction by which one reaches the plateau of holding 10% of the stock. Moreover, as pointed out above, the language of Sections 16(b) and 16(d) of the statute and the SEC's promulgation in 1935 of Rule 16b-2 suggest a contemporaneous view identical with that urged by petitioner.

Finally, the Ninth Circuit sought to bolster its conclusions by what we submit is an overly broad interpretation of a comment of this Court in the *Kern County* case relating to a tender offeror's calculations that it might be able to resell stock at a profit. Such matters, said Mr. Justice White:

> "do not represent the kind of speculative abuse at which the statute is aimed, for they could not have been based on inside information obtained from substantial stockholdings that did not yet exist." 411 U.S. at 597.

From this, the Ninth Circuit concluded that this Court "must have intended for section 16(b) to apply only after that person becomes a statutory insider."

* We note that in the instant case the Ninth Circuit specifically found Provident's transactions "voluntary" (7a-8a).

There are several considerations which lead to the conclusion that the quoted statement was offered only in the context of a hostile tender offer—a situation which is the very antithesis of that presented here, involving cooperative negotiation and exchange of information between issuer and purchaser prior to the time of purchase. In a recent decision, the Second Circuit commented as to *Kern County*: "We believe that *Kern County* holds the defensive merger situation to be *sui generis* in terms of §16(b) liability." *American Standard, Inc.* v. *Crane Co.*, [Current] CCH Fed. Sec. L. Rep. ¶94,924 (2d Cir. 1974). The Ninth Circuit would read the quoted language from *Kern County* far more expansively. Yet at the same time that the Ninth Circuit was exonerating Provident, it was also concluding that Provident's actions may have reflected "exactly the kind of speculative abuse that section 16(b) is designed to discourage" (8a) because of the cooperative negotiations that preceded such purchase.

While the Ninth Circuit emphasized the fact that prior to September 25, Provident owned no Foremost securities, the framework of the statute—as well as the legislative history discussed above—demonstrates that it is the potential for obtaining inside information, not the ripening of equity ownership, which is the important factor. Thus, for example, Section 3(a)(13) of the 1934 Act, 15 U.S.C. §78c

(a)(13), defines "purchase" as including "any contract to buy, purchase or otherwise acquire", and Section 3(a)(14), 15 U.S.C. §78c(a)(14), defines "sale" to include "any contract to sell or otherwise dispose of." Moreover, Section 3(a)(11) of the Act, 15 U.S.C. §78c(a)(11), defines an "equity security" to include any "stock or similar security" or "any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security • • •." If the draftsmen of the statute had in fact intended to exclude, *as a class,* transactions which "could not have been based on inside information obtained from substantial stockholdings that did not yet exist," they would not have defined purchase and sale to include contracts to buy and sell and they would not have defined "equity security" so as to include a warrant or a right or a convertible debenture.

Taking the second definitional considerations first, it cannot seriously be argued that one who has invested a comparatively small sum to purchase warrants or rights (which perhaps years later, and only after making a much larger payment, can be exchanged for 10%, or as the Ninth Circuit would have it, 10% first and then an incremental purchase, of an issuer's common stock) has a greater opportunity "by reason of his relationship to the issuer" to obtain inside information than does a responsible person who is negotiating in earnest through investment bankers to buy upwards of 10% (or for that matter 75% or more) of the equity of a major publicly-held company.

Indeed, in this case, it was Provident's purchase of convertible debentures that lead the Ninth Circuit to conclude that "Provident became a beneficial owner of more than 10 percent of a class of Foremost equity securities." (3a) When the purchase of convertible debentures gives one the right to acquire more than 10% of a class of equity securities, such purchase falls within the statute's reach. *Chemical Fund, Inc.* v. *Xerox Corp.,* 377 F. 2d 107 (2d Cir. 1967). This result is of course consistent with the definition of "purchase" in Section 3(a)(13). In neither the case of warrants or convertible debentures nor in the case of a contract to buy does the statute permit it to be said that a relationship sufficient to permit the abuse of inside information does not exist. Yet in each of these cases "substantial stockholdings • • • did not yet exist."

In passing, it should not escape notice that a second delivery of Debentures convertible into 236,464½ common shares of Foremost took place on October 20, 1969 (3a), after Provident became a statutory insider and before the October 21 sale. We do not urge that this second delivery be matched against the next day's sale, but only point out the anomaly of a construction that might arguably permit liability to flow only from this second delivery and not from the first. No one could seriously contend that the two deliveries under one contract involve different potentials for misuse of inside information. Nor should the result depend upon whether the second delivery stemmed from a separate contract. If the "closing" transaction, the sale, gives rise to a realizable profit, then it is hard to understand why, unless the statutory language clearly compelled it, the purchase by which one becomes a 10% holder should be distinguished from a purchase one day or one week later.

In conclusion, we submit, the language of *Kern County* relied upon by the Ninth Circuit was not directed to the issue present in this case. In fact, we submit that rather than supporting the decision of the Ninth Circuit with respect to the applicability of the statute to the initial purchase, the *Kern County* case suggests the opposite result. Such is the clear import of the following passages:

> "Unquestionably, one or more statutory purchases occurs when one company, seeking to gain control of another, acquires more than 10% of the stock of the latter through a tender offer made to its shareholders." 411 U.S. 582, 584.
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> "In the present case, it is undisputed that Occidental became a 'beneficial owner' within the terms of §16(b) when, pursuant to its tender offer, it 'purchased' more than 10% of the outstanding shares of Old Kern." *Id.* at 595
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> • • •
>
> "By May 10, 1967, Occidental had acquired more than 10% of the outstanding shares of Old Kern. It was thus a statutory insider when, on May 11, it extended its tender offer to include another 500,000 shares." *Id.* at 598

We note that in *Allis-Chalmers Manufacturing Co.* v. *Gulf & Western Industries, Inc.*, 372 F. Supp. 570 (N.D. Ill. 1974), *appeal docketed*, Nos. 74-1266 and 74-1267 (7th Cir.), the court stated that *Kern County* supported its finding that defendant's initial purchase of 10% of the issuer's stock was subject to Section 16(b) restrictions.

II

The other elements of Section 16 liability were correctly found to exist by the Ninth Circuit.

The sole ground for the Ninth Circuit's decision in favor of Provident in this case was its novel view of whether the initial purchase was subject to Section 16(b). It found that "the other" (or as we contend, "all the") basic elements of Section 16(b) liability—(1) a purchase and sale, (2) of any equity security of the issuer, (3) within any period of less than six months, (4) by a beneficial owner of more than 10% of any class of any security—were satisfied in accordance with long-standing precedent.

A. Provident's Purchase of the Debentures Made It the Beneficial Owner of More Than 10% of a Class of Equity Securities of Foremost.

1. Provident Purchased the Debentures on September 25, 1969.

As the Ninth Circuit held:

> "Provident exchanged its assets for Foremost stock. The only distinction between this transaction and the usual cash-for-stock sale is the nature of the consideration. • • • We see no meaningful distinction between consideration in the form of cash and consideration in the form of a corporate asset." (6a)

It has been held in several cases that a sale of assets in exchange for securities is a "purchase" of those securities within the meaning of Section 16(b). *Stella* v. *Graham-Paige Motors Corp.*, 132 F. Supp. 100, 102-03 (S.D.N.Y. 1955), *aff'd in part and rev'd in part*, 232 F. 2d 299 (2d

Cir.), *cert. denied,* 352 U.S. 831 (1956); *Marquette Cement Manufacturing Co.* v. *Andreas,* 239 F. Supp. 962, 965-66 (S.D.N.Y. 1965).

The Ninth Circuit further apparently held that the purchase took place on September 25, the date of the Purchase Agreement, as it found that "[t]he rights and obligations of the parties were fixed when the purchase agreement was executed" (5a). Such a holding is in accord with Section 3(a)(13) of the 1934 Act, 15 U.S.C. §78c(a)(13), which defines "purchase" as including "any contract to buy, purchase or otherwise acquire." See *Blau* v. *Ogsbury,* 210 F. 2d 426 (2d Cir. 1954), where it was held, in line with other cited Second Circuit cases, that an optionee purchased stock at the time when he mailed a notice to the corporation of his election to purchase rather than at the time he made payment for the stock. What was important for the court was that at the earlier date the insider's obligation was, for all practical purposes, fixed. Similarly, here, there were no unusual conditions upon Provident's obligations under the Purchase Agreement (see paragraph 7 of the Agreement in particular) (A35, ¶7).*

2. *Provident Acquired More Than 10% of a Class of Equity Securities of Foremost.*

There is also no question—and Provident raised none below—that by its purchase of the Debentures Provident acquired an equity security of Foremost. The common

* In fact, in the instant case, it makes no difference whether September 25, 1969, the date of the Purchase Agreement, or October 15, 1969, the date on which delivery of the Debentures was made, is considered the date of purchase because, as discussed below, the Ninth Circuit found the sale to have taken place on October 21, 1969, well within six months of either date.

stock of Foremost is clearly an "equity security." Moreover, Section 3(a)(10) of the 1934 Act, 15 U.S.C. §78c(a)(10), defines the term "security" as specifically including debentures, and Section 3(a)(11), 15 U.S.C. §78c(a)(11), defines the term "equity security" to include any security convertible into stock of the issuer. The Debentures are an equity security within the Section 3(a)(11) definition because they are convertible into shares of common stock.

Looking at September 25, the date of the Purchase Agreement, Foremost's outstanding common stock, including the shares issuable to Provident upon a hypothetical conversion of the Debentures, comprised about 12,700,000 shares. By the Purchase Agreement, Provident had contracted to purchase Debentures convertible into 1,600,000 shares, more than 10%. On the other hand, if October 15 is considered the purchase date of the $40,000,000 principal amount of Debentures delivered then, Foremost's outstanding common stock, upon conversion of the Debentures on that date, would have consisted of about 12,400,000 shares and Provident would have held about 1,300,000 of such shares, again more than 10%. (It is not necessary to even consider in this respect the effect of the delivery into escrow on October 15 of $2,500,000 principal amount of Debentures, convertible into 81,539½ shares.) The later delivery of additional Debentures on October 20 merely increased Provident's percentage holdings, and did not alter its position as a more than 10% owner.

3. *By Virtue of Its Purchase of Debentures, Provident Became the Beneficial Owner of the Debentures.*

Provident contended in the court below that it did not become the beneficial owner of the securities by virtue of the September 25 Purchase Agreement because it allegedly acquired the Debentures as agent and trustee for its shareholders by virtue of its adoption of a Plan of Dissolution on September 26. The Ninth Circuit rejected this argument without discussion, simply stating that Provident "became a beneficial owner" of the securities by virtue of the total transaction (3a).

The argument that Provident was not a beneficial owner after September 26, 1969, flies in the face of the Forms 3 and 4 filed by Provident with the SEC on October 31, 1969 (A53, A55) which specifically state that Provident was the "beneficial owner of more than 10% of the Company's 6% Convertible Subordinated Debentures due June 13, 1994."*

According to one of the draftsmen of the Exchange Act, Mr. Thomas Corcoran, the phrase "beneficial ownership" is "the broadest term you can have." 1934 Hearings, pt. 15, at 6556. According to SEC Securities Exchange Act Release No. 7793 (January 19, 1966) (2 CCH Fed. Sec. L. Rep. ¶26,032) one of the basic concomitants of "beneficial ownership" is "the ability to exercise a controlling influence over the purchase, sale or voting of * * * securities." All of these Provident clearly had.

* "If a record owner—or any person who might be deemed a beneficial owner but does not think he is—wants to protect himself, he may file a report and disavow any implication that the filing is an admission of beneficial ownership." 2 L. Loss, SECURITIES REGULATION 1100 (2d ed. 1961). This Provident did not do.

The rule in general is that "a corporation obviously beneficially owns any securities it holds of another company. Such securities are an asset of the corporation." Feldman & Teberg, *Beneficial Ownership under Section 16 of the Securities Exchange Act of 1934*, 17 W. RES. L. REV. 1054, 1080 (1966). It could be argued that in every situation in which a corporation owns stock that stock is "beneficially owned" by the shareholders as well. Whether such an argument has any merit or not, it has never been upheld in order to exonerate a corporation, which has all the indicia of ownership including the power to sell and the right to receive dividends or interest, from its Section 16 responsibilities.

Thus, examination of the Underwriting Agreement (A 135) signed on October 21, 1969, shows that under paragraph 5(b)(A), Provident's counsel was required to, and on October 28, 1969, in fact did, furnish to the underwriters its opinion that:

> "* * * the Selling Debentureholder (Provident) has valid marketable title to the Debentures and has the legal right and power to enter into this agreement and to sell, transfer and deliver the Debentures to the Underwriters. * * *" (A135, ¶5(b)(A))

Under paragraph 9(a)(i) of the Underwriting Agreement, Provident made a warranty to the same effect and also represented that it owned and held on October 21 and would own or hold on October 28, the Debentures "free and clear of all liens, claims, encumbrances and equities * * *" (A135, ¶9(a)(i)).* In its letter of October 15, 1969, to the SEC,

* In paragraph 9(a)(ii) Provident further warranted that in furnishing information to Foremost for use in the Registration Statement or Prospectus, it did not make an untrue statement of a "material fact" and did not "omit to state a material fact," and in paragraph 9(b) Provident agreed to indemnify Foremost and the underwriters for any such misstatement or omission (A135, ¶¶9(a)(ii), 9(b)).

Provident referred to itself as the "selling stockholder" to be named in the Prospectus (A127). The payment by the underwriters of the purchase price (including interest) of the Debentures was made to Provident at the closing, not to its shareholders and not to it in any agency or other fiduciary capacity (A32). In such circumstances, Provident can hardly deny that it was the beneficial owner of the Debentures.

Even if Provident's argument that it was a "trustee" or a "fiduciary" were accepted, it would be of no help; at most, it would mean that both Provident and its shareholders were "beneficial owners." See Feldman & Teberg, *Beneficial Ownership under Section 16 of the Securities Exchange Act of 1934,* 17 W. Res. L. Rev. 1054, 1074 (1966). But it is not necessary to reach that point here for Provident was not a "trustee", "agent" or "fiduciary" for its shareholders during liquidation to any greater extent than an on-going corporation ever is. It is clear under California law that the Board of Directors of a corporation in voluntary liquidation maintains its status as a Board of Directors, and the Board members do not become trustees for the shareholders. See Calif. Corp. Code §4800, 4801; *Hartman* v. *Hollingsworth,* 255 C.A.2d 579, 63 Cal. Rptr. 563 (1967); *Chase* v. *Super-Cold Corp.,* 163 C.A.2d 83, 328 P.2d 812, 814 (1958).

Provident argued below that all its transactions in the Debentures "were for its shareholders and for its shareholders' benefit." To the extent that this statement is intended to be anything more than a truism regarding the relationship between a corporation and its shareholders, it is, as demonstrated above, without substance.

B. Provident Sold the Debentures Within Six Months of the Date of Purchase.

1. The Sale Took Place on October 21.

The Ninth Circuit held that the sale of the Debentures took place on October 21. On that date,

> "• • • when Provident executed the underwriting agreement, it was bound and the price was fixed. • • • As to Provident, the sale was at that date complete, subject only to the usual conditions precedent to closing." (10a)

Many considerations support this conclusion, including Provident's own Form 4, which indicates a date of sale of October 21, 1969. Moreover, Section 3(a)(14) of the 1934 Act, 15 U.S.C. §78c(a)(14), defines "sale" to include "any contract to sell or otherwise dispose of • • • unless the context requires otherwise." It is essential in the context of Section 16(b) that a contract of sale be considered a "sale". Otherwise, an insider could easily avoid the proscriptions of Section 16(b) by entering into a contract to sell stock within the six-month period, thereby fixing his profit, but provide that the closing take place after the six-month period. In order to prevent such simple evasion of Section 16(b), the date of the sale must, as the statutory definition recognizes, be considered to be the date of the contract of sale. At that point, the rights of the seller and purchaser become fixed and any profits received by the insider at the closing may be said to have been "realized" under the terms of the contract of sale. This was the position reached by the District Court in *Stella* v. *Graham-Paige Motors Corp.,* 132 F. Supp. 100, 105-06

(S.D.N.Y. 1955), *aff'd in part and rev'd in part,* 232 F. 2d 299 (2d Cir.), *cert. denied,* 352 U.S. 831 (1956) (this holding was not disturbed on appeal). The District Court there rejected the argument that the sale took place at the closing held after the six-month period rather than at the time of the contract of sale which was within the statutory period.

As the Ninth Circuit recognized, the existence of routine conditions of closing cannot alter the result. The statutory scheme would be destroyed if liability could be avoided by the mere addition of a condition which common experience indicates will be met with the mere passage of time. In *Stella* v. *Graham-Paige Motors Corp., supra,* defendant argued that the sale did not take place until stock to fulfill the contract of sale had been released from a voting trust. The District Court rejected this contention:

> "I cannot see that Graham-Paige's inability to acquire a particular block of 155,000 shares to fulfill its commitments would have any effect upon those commitments as 'sales' within the meaning of the statute. For example, a contract for the sale of stock which the seller expected to fill by delivering stock which was subject to a pledge at the time of the making of the contract would result in a 'sale' as of that time rather than as of the date that the seller succeeded in redeeming it from the pledge." 132 F. Supp. at 106.

Provident on October 21, 1969, bound itself to sell the Debentures and to take a short-swing profit, within six months after their purchase. It was at this time that, after receiving the Debentures, Provident insulated itself from the continuing ordinary risks of the market by entering into an agreement which set the sale price of the Debentures at

101¼% of their aggregate principal amount, plus interest. The conditions of Provident's obligations under the Underwriting Agreement—that the Registration Statement be effective, that no stop order be issued, that Foremost's counsel submit a written opinion to Provident (A135, ¶6)—were ready to fall into place and Provident could not prevent their occurrence. As is always predetermined when an underwriting agreement is signed, the SEC had been alerted to make the registration statement effective, and indeed it was made effective later on the same day, October 21. It was thus on October 21 that Provident exercised its speculative judgment and insulated itself from further market risks and thus it was at this point that the "sale" took place for purposes of Section 16(b). *Blau* v. *Ogsbury,* 210 F. 2d 426, 427 (2d Cir. 1954).

2. *Provident Was the Beneficial Owner of 10% of the Equity Securities of Foremost at the Time of Sale.*

Provident further argued below that by the time of the sale, it had divested itself of beneficial ownership of the requisite amount of Debentures. One branch of this argument depends upon fixing a sale date of October 28, and arguing that Provident's distribution of $22,227,000 principal amount of Debentures on October 24 reduced its holding to less than 10%. However, this contention is of no avail if, as the Ninth Circuit correctly held, the sale date is held to be October 21. This contention is also in conflict with Provident's Form 4 which stated that it was a 10% owner at the time of sale, and that the $22,227,000 of Debentures were distributed as a liquidating dividend on October 24, 1969, three days *after* the sale (A55).

The second branch of the argument—not discussed by the Ninth Circuit—depends upon an assertion that the distribution of the dividend took place in some metaphysical fashion at the time of a resolution of the Provident Board of Directors on October 13, 1969, prior to the Underwriting Agreement of October 21, 1969. (See p. 8 *supra*). All that this resolution—subsequently repudiated—provided was that after payments had been made with respect to the Preferred Stock, the officers were to distribute the Debentures "as received" to shareholders of record upon dates to be then established by the officers "as expeditiously as possible" (A118). There is no authority which supports Provident's contention that its shareholders had "vested rights" in the Debentures at that point.

First, because the resolution did not fix a record or payment date but only stated that the Debentures were to be distributed "as received" upon dates to be fixed by the officers, there was never established as of any fixed time an enforceable debtor-creditor relationship between the corporation and its shareholders. Second, Provident obviously did not itself treat the resolution as creating a debtor-creditor relationship because it deviated from the terms of the resolution and never carried it out. It never distributed the Debentures—described specifically and significantly in the resolution as "assets of the Corporation" and directed to be distributed to the shareholders "pro rata" and "as received"—in the manner contemplated by the resolution. Instead, it sold $25,000,000 worth of them. Third, the authorities relied upon by Provident below which speak of shareholders' "vested rights" in dividends all dealt with dividends of a going corporation, not liquidating dividends as were here involved. Unlike

this liquidating dividend, all of those non-liquidating dividends had been declared to be payable on a fixed future date. In D. KEHL, CORPORATE DIVIDENDS (1941), the distinction is made at any early point:

> "Quite different considerations apply to payments which purport to be liquidations and payments which purport to be made from profits. It is the latter type of payment which is peculiarly the province of corporate dividend law • • •" *Id.* at 23 (footnote omitted).

This distinction is illustrated in the California Corporations Code with the contrast between Section 5000 *et seq.* dealing with Distributions in Liquidation, and Section 1500 *et seq.* dealing with Dividends. It is clear that declaration of distributions in liquidation under the former sections (even had the resolution fixed a date for payment and a record date, neither of which it did) cannot create a debt or a vested right against the corporation. Under Section 5000, distribution of the corporation's assets cannot be made until it has been determined "that all the known debts and liabilities • • • have been paid or adequately provided for • • •"; and then distribution must be made among the shareowners "according to their respective rights and preferences." The Plan of Liquidation adopted by Provident on September 26, 1969 (A102) provided that the liquidation preference in respect to the Preferred Stock must have been paid in cash before any other distributions of assets of the corporation were to be made to the common stockholders, and, in addition, explicitly provided that funds would have to be reasonably retained to meet claims against Provident or its assets (A104). The dividend resolution of October 13 itself stated that distribution of the

corporate assets (including the Debentures) was dependent upon "full and final payment with respect to the Preferred stock" having been made prior to such distribution (A 120). In no sense can the mere Board resolution of October 13, which was never carried out, and which was subject to numerous contingencies and legal requirements, be held to have divested Provident of the beneficial ownership of the Foremost Debentures as of October 13.

C. The Transction Resulted in Profit to Provident.

The Purchase Agreement called for the exchange of $54,000,000 worth of Provident's assets for $54,000,000 principal amount of Debentures. Promptly after their delivery to Provident, $25,000,000 principal amount of the Debentures were sold in a public offering, and Provident received $25,366,666.66. Suffice it to point out for present purposes that in the California state proceedings in connection with its winding up, Provident admitted that, without reference to interest received on the Debentures, it received $312,500 "from the sale of the Debentures in excess of their face amount." The California court has set aside $804,000 "for Foremost's Section 16(b) claim" (A62). Although the parties excluded the question of computation of profit from the summary judgment motions, the Ninth Circuit noted that Provident had received $366,666.66 "in excess of the principal amount of the debenture * * *" (9a). Foremost expects, at the appropriate time, to show that the realizable profit was much greater than $312,500 or $366,666.66. However that may turn out, there can be no question that Provident obtained a profit on these transactions, and that this case should be remanded for hearing

to determine the precise amount of such profit. Contrary to the intimation of the District Court below, that the profit may arguably have been relatively small in comparison with the over-all transaction is certainly no ground for refusing to find liability. In *Steinberg* v. *Sharpe*, 95 F. Supp. 32, 34 (S.D.N.Y. 1950), *aff'd per curiam*, 190 F. 2d 82 (2d Cir. 1951), for example, the total recovery, out of which attorneys' fees of the stockholder-plaintiff were paid, was only $168.75.

III

There is no ground for refusing to carry out the statutory mandate of imposing liability on Provident.

The Ninth Circuit rejected Provident's contention below that the adoption of a "pragmatic approach" by this Court in *Kern County* served to exonerate it from Section 16 liability. The Ninth Circuit decision was on two grounds: (1) the transaction was not of an unorthodox type which would give rise to a pragmatic test; (2) even if the transaction were to be considered unorthodox, it involved "the potential for speculative abuse of inside information."

A. The Transaction Was Not Unorthodox.

As we have demonstrated above, the transaction involved the transfer of assets for stock (convertible debentures). Such transactions have long been held to constitute "purchases" of the stock. See *e.g.*, *Stella* v. *Graham-Paige Motors Corp.*, 132 F. Supp. 100, 102-03 (S.D.N.Y. 1955), *aff'd in part and rev'd in part*, 232 F. 2d 299 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956). The Ninth Circuit saw

no meaningful distinction based on the form of consideration involved, and saw no reason to treat the Provident-Foremost transaction as anything other than orthodox (6a, 5a).

As the Ninth Circuit further pointed out, the rights and obligations of the parties, including the price, were fixed by the execution of the Purchase Agreement and the transaction was not a record-keeping maneuver, but "was an actual transfer of stock for assets" (5a). Nor did the transaction involve the reclassification or conversion of one type of security into another, or an involuntary purchase or sale, two further types of unorthodox transaction which have been discussed by the courts. See *e.g., Blau* v. *Max Factor & Co.*, 342 F. 2d 304, 306 n.3 (9th Cir.), *cert. denied*, 382 U.S. 892 (1965) and *Ferraiolo* v. *Newman*, 259 F. 2d 342, 346 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

With respect to the question of voluntariness, the Ninth Circuit stated:

> "There is no evidence in this case to suggest that Provident was forced to enter into any of the transactions. There is evidence, however, to show that Provident's management was aware of the section 16(b) problem and entered the transaction in spite of the possibility that it might be held liable for the profits. Provident has not suggested that it would have suffered any detriment had it not completed the transactions when it did." (7a-8a)

This finding is compelled by the record. Provident attempted to base an argument below on the assertion that it would have preferred to have received cash rather than

Debentures. That hardly means that its receipt of the latter was not voluntary. Indeed, if one is to assume that a cash deal would have been pegged at the face amount of the Debentures, Provident's argument is to the effect that Debentures which were quickly to be sold at 101¼% of face value had to be thrust upon it against its corporate will. And no claim was made that the sale on October 21 was anything but Provident's free choice. Foremost did not in any way insist upon, or even encourage, the sale of the Debentures, much less insist upon such sale within six months. If Provident had chosen to retain the Debentures (and Provident had five years within which to call upon Foremost for a registration statement (A135)), Foremost could not have forced it to sell nor to execute the Underwriting Agreement, and, as noted by the Ninth Circuit, at the time that Provident did enter into the contract to sell, it and its shareholders were fully aware of the "Section 16(b) Problem" which its President had outlined at the October 13 informal shareholders' meeting (A80, A126).

B. The Transaction Involved the Potential for Speculative Abuse.

The Ninth Circuit went further though. Hypothetically assuming that the transaction was unorthodox, it discussed whether there was a potential for speculative abuse—in particular, whether the officer-director or 10% shareholder could reasonably be expected to have had access to inside information?

In this connection, the Court first noted that the statute itself presumes access to inside information on the part of

a 10% beneficial owner (7a). See *e.g., Newmark* v. *R.K.O. General, Inc.*, 425 F. 2d 348, 356 (2d Cir.), *cert. denied*, 400 U.S. 854 (1970), citing 2 L. Loss, Securities Regulation 1060-61 (2d ed. 1961). The Court then considered the *Kern County* case as holding that such presumption can be rebutted where, as in a contested tender offer situation, the hostility of management precludes any real possibility of access to inside information on the part of the defeated offeror.* However, the Court found, no such situation existed here:

> "* * * Provident has not demonstrated that the Foremost management was hostile. To the contrary, the general cooperation involved in the transaction would indicate that Provident conferred intimately with the Foremost management and could well have had access to confidential corporate information." (7a)

The Court went on to illustrate the type of abuse which could occur in this type of transaction:

> "For example, assume Provident learned that Foremost had decided not to declare a dividend in order to maintain the capital it would need to develop the real estate just acquired from Provident. On the basis of this information, Provident might have reasoned that the market value of Foremost stock would rise in response to the news of the acquisition and then fall in response to the news of the decision not to declare a dividend. Provident might have concluded that it should sell its stock just after the acquisition news, but just before the dividend news, became public. Such trading is exactly the kind of speculative abuse that section 16(b) is designed to discourage." (8a)

* *Cf.* Makofsky v. Ultra Dynamics Corp., [Current] CCH Fed. Sec.L.Rep. ¶94,832 (S.D.N.Y. 1974), where the potential for speculative abuse was found to exist when the defeated offeror had placed representatives on the Board of Directors.

Indeed there can be no doubt, *based simply on the exhibits submitted by Provident below,* that it possessed knowledge far superior to that of either Foremost or the average Foremost security holder regarding the value of the real estate properties and unmarketable securities transferred to Foremost by Provident. The non-public nature of the information regarding the value of the assets is borne out by the provisions of the Purchase Agreement (A35): for example, in paragraph 5(a) of the Purchase Agreement, the confidentiality of the information regarding the business and properties of Provident was specifically provided for, in case the Purchase Agreement was not consummated (A35, ¶5(a)). In paragraph 5(d), Provident agreed to furnish Foremost, after the closing, "information, evidence, testimony and other assistance" regarding assets and properties acquired by Foremost in case of any disputes with third parties involving those properties (A35, ¶5(d)).

Specifically, what was sold to Foremost included real estate assets of Provident and 38.9% of the stock of an entity entitled Crocker Real Estate Company which in turn owned real estate and securities. The assets also included certain securities which were not otherwise readily marketable. The value of these securities, the equity interest in the real estate assets, and the stock of Crocker was no less than approximately $26,000,000 (A25), obviously a significant amount; however, the nature and value of all these assets were best known by Provident. In analyzing Provident's net worth prior to the Purchase Agreement, Provident's investment bankers, Dillon Read, had commented that the value of the real estate properties "is a very complex problem and probably will take years to work out" (A152).

More importantly, Dillon Read had been instructed to seek out a suitable purchaser for Provident's assets and "to negotiate and analyze * * * any offers." Provident thus is charged with all of the knowledge about Foremost that resulted from Dillon Read's negotiation and analysis as well as with what Provident learned from its direct negotiations with Foremost. But it is charged even more specifically with knowledge of what it sold to Foremost.

Moreover, the Purchase Agreement gave Provident control over how long it would hold the Foremost Debentures—in other words, it gave Provident the power or potential to speculate with the inside information it possessed regarding the value of the properties delivered to Foremost or by virtue of any other inside information it might have obtained about Foremost in the course of, or after, becoming a 10% beneficial owner. There was no requirement that the Debentures be sold at any particular time. On the other hand, under paragraph 5(k)(i) of the Purchase Agreement, Foremost was required by Provident to use its best efforts to cause a Registration Statement covering up to $25,000,000 of the Debentures to be filed, to effect registration "as expeditiously as practicable" and to qualify the Indenture. Indeed, under subparagraphs (ii) and (iii) of paragraph 5(k), Foremost, upon request, was required to use its best efforts to register the Debentures for two consecutive thirty-month periods after the closing date (A135, ¶5(k)). Thus, the Purchase Agreement contemplated possible sales of the Debentures for up to five years after the closing date of the Purchase Agreement. It was Provident's choice to sell almost immediately.

The fact that this transaction involved such potential for abuse demonstrates not only that the "hostile tender

offeror" rule of *Kern County* should not apply, but also that the rule adopted by the Ninth Circuit below exempting the initial purchase from Section 16 coverage unnecessarily frustrates the statutory purpose of preventing the unfair use of inside information.

IV

Provident was not a "liquidating agent" within the meaning of Rule 16a-4.

Provident has asserted throughout this litigation that even if it were otherwise subject to Section 16(b), the Debentures purchased and sold by it were exempt from the prohibitions of Section 16(b) by virtue of Rule 16a-4 (17 C.F.R. §240.16a-4), which by its terms provides exemption for securities "held" by executors, administrators, guardians or committees for an incompetent, receivers, trustees in bankruptcy, assignees for the benefit of creditors, conservators, "liquidating agents, and other similar persons duly authorized by law to administer the estate or assets of other persons," the exemption being limited to the twelve-month period following such persons' "appointment and qualification." Both the District Court and the Ninth Circuit chose to ignore this argument.

It is clear that the burden of proving an exemption from Section 16 is on the person who claims it. *Rheem Manufacturing Co.* v. *Rheem,* 295 F. 2d 473, 475 (9th Cir. 1961). On the face of the Rule itself, Provident does not qualify: it was not a third party "authorized by law to administer the estate or assets of other persons"; it was not under court supervision until at least August 1970 (A56-69). Moreover, it never received any "appointment" nor took any steps constituting "qualification" as a fiduciary; cer-

tainly it was never appointed or qualified by a court. And, as explained below, the exemptive Rule is also limited to securities "held" by fiduciaries, that is, those that devolve upon the fiduciary. It does not apply where, as Provident urged here, the so-called "fiduciary" both bought and sold the securities during the period when it allegedly had fiduciary status.

It has been said that the limited exemption furnished by Rule 16a-4 is justified by "the limited life of the estate, the supervision of the court and the publicity from periodic filing of accounts. * * *" Cook & Feldman, *Insider Trading under the Securities Exchange Act*, 66 HARV. L. REV. 385, 391 (1953). Obviously such rationale cannot apply to voluntary dissolution procedures under California law, in which the putative "liquidating agent" is self-appointed and subject only to self-imposed qualifications, if any, and where no court supervision is required, no time limit is prescribed (although Provident's shareholders did, presumably with an eye to personal tax considerations, voluntarily impose a one-year deadline on the dissolution (A145)) and no periodic filing of accounts is required.

Provident placed great importance below on the adoption of the Plan of Dissolution on September 26, 1969 (A 102-107). However, the Plan itself repeatedly describes the assets and properties to be sold as "assets of Provident" or "its assets," not Provident's shareholders' assets (A 102-107). In addition, Provident represented to the SEC by letter of October 15, 1969 that it was the selling shareholder of the Foremost securities under registration (A 127), and on October 28 Provident's counsel opined to the underwriters that Provident had title to the Foremost Debentures and the right and power to contract to sell them

and to transfer and deliver them (A135, ¶5(b)(A)). None of these recitals made any reference to any fiduciary status. The same is true with respect to the Forms 3 and 4 dated October 31 filed by Provident (A53, A55).*

Moreover, the Plan could have been revoked by a majority vote of the shareholders prior to distribution. Calif. Corp. Code §4606.** The power of revocation is very important because it gave Provident power to structure the transaction to its own ends; Rule 16a-4 was not designed to exempt arrangements by which a party could declare itself a "liquidating agent," engage in securities transactions, and then cause the liquidating agent status to be revoked.

Further, there is nothing in the California law which suggests that, simply by adopting a plan of dissolution, Provident became an agent or similar person, administering "the estate or assets of other persons." Indeed, §5000 of the California Corporations Code provides that after the debts and liabilities of the corporation have been paid or provided for, "the directors shall distribute all the remaining *corporate assets* among the shareholders. * * *" (em-

* In these forms Provident referred to itself as the beneficial owner of the Debentures, stated that its ownership was "direct," and stated nothing regarding an alleged status as "agent" or "trustee," although the SEC forms invite the disclosure of anything else "deemed relevant" by the person filing. (Instruction 11 to Form 3, Instruction 12 to Form 4, 2 CCH Fed. Sec. L. Rep. ¶¶33,701 and 33,721 respectively.) Indeed, if Provident were truly "exempt" or had considered itself so, it need not have filed these reports at all or at least it could have availed itself of the specific right afforded by SEC Rule 16a-3 to disclaim beneficial ownership by an express statement to that effect.

** There is indeed a second method of revocation: §4607 of the California Corporations Code which provides that certain persons, including the corporation itself or holders of 5 per cent or more of its outstanding shares, may petition the court for judicial supervision of winding up; and §4618 of the Code which provides that with respect to dissolutions so supervised the court can revoke the election to wind up and dissolve.

phasis added). Clearly, then, until the time of distribution, the assets are the corporation's, not the shareholders'. Moreover, under California law, adoption of the Plan of Dissolution did not alter Provident's responsibilities, or those of its officers and directors.*

Provident contended below that it both purchased and sold the Debentures as a "liquidating agent." The Rule, however, only exempts securities which are "held" by the fiduciary, *i.e.*, which devolved upon him from the insider's estate. As Loss states:

> "The primary purpose of the rule, in other words, is to permit liquidation without filing reports and without liability under §16(b) even though the insider (or late insider) happened to buy within less than six months before the fiduciary's sale." 2 L. Loss, SECURITIES REGULATION 1111 (2d ed. 1961).

Thus, the exemption does not apply to a purchase *and* sale by the fiduciary (or a purchase by the fiduciary after an insider's sale).**

The Rule was not designed, we submit, to allow able and competent parties having full control over their status

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* Section 4800 of the California Corporations Code provides that the Board of Directors will continue to function as a Board and shall have full powers to wind up and settle the corporation's affairs. Section 4801 provides that after commencement of dissolution proceedings the directors are to act "in the name and on behalf of the corporation" with respect to numerous matters. *See* Chase v. Super-Cold Corp., 163 C.A.2d 83, 328 P.2d 812 (1958) in which it was specifically held that the duty of care of the officers and directors after the vote for dissolution remains that of officers and directors, and that they do not have a trustee's duties or liabilities.

***See also* Rule 16a-4(b) which provides that after the one-year exemption period, Sections 16(a) and 16(b) will apply only if the estate itself is a 10 per cent owner; *i.e.*, the estate of a deceased director would not be required to file. This, Loss states, "indicates that the Commission views the fiduciary as standing in the insider's shoes during that year [of exemption]." *Op. cit.* at p. 1111. Therefore, securities purchased by the fiduciary (in contrast to those purchased by the insider) do not fall within the exemption.

and the disposition of their assets, to structure their affairs so their transactions will fall within it. It exempts only those securities "held" in the estate of the decedent or among the assets of a corporation to which the fiduciary succeeds: therefore, had Provident attempted to structure the transaction so that it would purchase and receive the securities in the status of an exempt person and would also sell those securities within six months thereafter, the attempt would have failed, both on grounds of the language of the Rule and on grounds of policy. In fact, no such attempt was made at the time of the transaction; rather the argument was first advanced in the courts below as an *ex post facto* rationalization of a completed transaction.

Conclusion

Provident became a 10% beneficial owner of Foremost equity securities by a voluntary purchase, voluntarily sold such securities within a six-month period, realizing a profit, and thus is liable under Section 16 (b). In these circumstances, the judgment below must be reversed, and the case remanded with directions to the District Court to grant summary judgment to Foremost on the issue of liability and to set the case down for hearing as to the amount of damages.

Dated: New York, New York
April 18, 1975

Respectfully submitted,

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Statutory Appendix

Securities Exchange Act of 1934, 15 U.S.C. §78a, *et seq.*

Section 3:

(a) When used in this chapter, unless the context otherwise requires:

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(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

(11) The term "equity security" means any stock or similar security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be

of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security.

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(13) The terms "buy" and "purchase" each include any contract to buy, purchase, or otherwise acquire.

(14) The terms "sale" and "sell" each include any contract to sell or otherwise dispose of.

Section 16:

(a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 78*l* of this title, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security on a national securities exchange or by the effective date of a registration statement filed pursuant to section 78*l*(g) of this title, or within ten days after he becomes such beneficial owner, director, or officer, a statement with the Commission (and, if such security is registered on a national securities exchange, also with the exchange) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been a change in such ownership during such month, shall file with the Commission (and if such security is registered on a national securities exchange,

shall also file with the exchange), a statement indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month.

(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by

rules and regulations may exempt as not comprehended within the purpose of this subsection.

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Rules under Section 16

Rule 16a-3. Disclaimer of Beneficial Ownership.

Any person filing a statement may expressly declare therein that the filing of such statement shall not be construed as an admission that such person is, for the purpose of Section 16 of the Act, the beneficial owner of any equity securities covered by the statement.

Rule 16a-4. Exemptions From Sections 16(a) and 16(b).

(a) During the period of twelve months following their appointment and qualification, securities held by the following persons shall be exempt from Sections 16(a) and 16(b) of the Act:

(1) Executors or administrators of the estate of a decedent;

(2) Guardians or Committees for an incompetent; and

(3) Receivers, trustees in bankruptcy, assignees for the benefit of creditors, conservators, liquidating agents, and other similar persons duly authorized by law to administer the estate or assets of other persons.

(b) After the twelve month period following their appointment or qualification the foregoing persons shall be required to file reports with respect to the se-

curities held by the estates which they administer under Section 16(a) and shall be liable for profits realized from trading in such securities pursuant to Section 16(b) only when the estate being administered is a beneficial owner of more than 10 percent of any class of equity security (other than an otherwise exempted security) which is registered pursuant to Section 12 of the Act.

(c) Securities reacquired by or for the account of an issuer and held by it for its account shall be exempt from Sections 16(a) and 16(b) during the time they are held by the issuer.

Rule 16b-2. Exemption from Section 16(b) of Certain Transactions Effected in Connection with a Distribution.

(a) Any transaction of purchase and sale, or sale and purchase, of a security which is effected in connection with the distribution of a substantial block of securities shall be exempt from the provisions of Section 16(b) of the Act, to the extent specified in this rule, as not comprehended within the purpose of said section, upon the following conditions:

(1) The person effecting the transaction is engaged in the business of distributing securities and is participating in good faith, in the ordinary course of such business, in the distribution of such block of securities;

(2) The security involved in the transaction is (A) a part of such block of securities and is acquired

by the person effecting the transaction, with a view to the distribution thereof, from the issuer or other person on whose behalf such securities are being distributed or from a person who is participating in good faith in the distribution of such block of securities, or (B) a security purchased in good faith by or for the account of the person effecting the transaction for the purpose of stabilizing the market price of securities of the class being distributed or to cover an overallotment or other short position created in connection with such distribution; and

(3) Other persons not within the purview of Section 16(b) of the Act are participating in the distribution of such block of securities on terms at least as favorable as those on which such person is participating and to an extent at least equal to the aggregate participation of all persons exempted from the provisions of Section 16(b) of the Act by this rule. However, the performance of the functions of manager of a distributing group and the receipt of a bona fide payment for performing such functions shall not preclude an exemption which would otherwise be available under this rule.

(b) The exemption of a transaction pursuant to this rule with respect to the participation therein of one party thereto shall not render such transaction exempt with respect to participation of any other party therein unless such other party also meets the conditions of this rule.

California Corporations Code

Part 9: Winding Up and Dissolution

§4607. Judicial supervision of winding up: Petition and notice: Provision in order to protect rights of purchasers of homes. If a corporation is in the process of voluntary winding up, the superior court of the county in which the principal office of the corporation is located, upon the petition of (a) the corporation, or (b) the holders of 5 percent or more of the numbers of its outstanding shares, or of (c) three or more creditors, or of (d) three or more persons who have purchased homes from a construction corporation, and upon such notice to the corporation and to other persons interested in the corporation as shareholders or creditors as the court may order, may make orders and adjudge as to any and all matters concerning the winding up of the affairs of the corporation.

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§4618. Same: Revocation of election to wind up. The jurisdiction of the court includes the revocation of the election to wind up and dissolve by the shareholders, and the making of orders for the withdrawal and termination of proceedings to wind up and dissolve, subject to conditions for the protection of shareholders and creditors.

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§4800. Directors to act as board in voluntary proceedings: Election of officers: Acts authorized by majority of directors as binding. When voluntary proceedings for winding up or dissolution of a corporation have been commenced, the board of directors shall continue to act as a

board and shall have full powers to wind up and settle its affairs. If the directors have not theretofore elected officers of the corporation pursuant to Section 821, the directors shall elect them and such assistants as the directors deem proper. Any act authorized or approved by a majority of the directors acting as a board is valid and binding as though authorized and consented to by all of the directors.

§4801. Same: Powers and duties of directors. The powers and duties of the directors after commencement of such proceedings include but are not limited to, the following acts in the name and on behalf of the corporation:

(a) To elect officers and to employ agents and attorneys to liquidate or wind up its affairs.

(b) To continue the conduct of the business insofar as necessary for the disposal or winding up thereof.

(c) To carry out contracts and collect, pay, compromise, and settle debts and claims for or against the corporation.

(d) To defend suits brought against the corporation.

(e) To sue, in the name of the corporation, for all sums due or owing to the corporation or to recover any of its property.

(f) To collect any amounts remaining unpaid on subscriptions to shares or any overpayments or unlawful distributions.

(g) To sell at public or private sale, exchange, convey or otherwise dispose of, all or any part of the assets of the corporation upon such terms and conditions and for such considerations as such board deems reasonable or expedient, and to execute bills of sale and deeds of conveyance in the name of the corporation. If sale or exchange of all or substantially all of the assets of a corporation for profit is made for a consideration consisting in whole or in part of shares, obligations, or securities of another corporation domestic or foreign, or any consideration other than money, it shall be approved or ratified by the vote or written consent of holders of shares entitled to exercise a majority of the voting power of the corporation, either before or after the action of the directors.

(h) In general, to make contracts and to do any and all things in the name of the corporation which may be proper or convenient for the purposes of winding up, settling, and liquidating the affairs of the corporation.